

# Estate Planning

## Fast Faxes

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Estate, Tax and Family Wealth Preservation Planning For Advisors

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## The Private Annuity: A Business and Family Estate Planning Tool

Happy  
1040!

Ninety percent of all U.S. Businesses are family owned, yet only about 25% continue to be operated by the next generation.

One reason for the poor succession rate is the tax and financial complexity such a transition involves.

The simplest way to structure a sale of a business to children is an outright sale. However, in most cases, the children lack the financial means to buy the company outright. So, alternative methods of purchase must be explored.

### One viable alternative:

The owner receives annuity payments from the children to cover the purchase price.

**Caution:** The purchase price must be based on an accurate appraisal of the business. This will avoid the IRS claim that the parent really only made a *gift* of the business to his/her children.

### Using Private Annuities

**How it works:** The parent sells his interest in the business to the children in exchange for the children's promise to pay the parent an annuity for life. In most cases the annuity payments are figured by dividing the purchase price of the business by the parent's life expectancy.

**Warning:** Setting up a private annuity requires careful calculations, including an interest rate based upon 120% of the federal midterm rate for the month in

which the valuation is used.

### Advantages

- ☞ The value of the business is immediately removed from the parent's estate. When the parent dies, there is nothing to include in the estate, since the annuity ends on the parent's death.
- ☞ The parent receives an *income for life*. Payments must be continued even if the parent outlives his life expectancy, or the children sell the stock.
- ☞ Income tax on the gain on the sale is spread over the parent's life expectancy—a portion of each annuity payment represents capital gain, ordinary income and a nontaxable return of capital.

### Disadvantages

The advantages of a sale financed by a private annuity are considerable. However, there are downsides to consider...

- ☞ The annuity cannot be secured. The parent must have complete trust that the child will make the payments.
- ☞ The children may not have sufficient money to pay the annuity. The older the parent is at the time of sale, the larger the annuity payment.

Recently released IRS tables reflect increased life expectancies. Since the parent is expected to live longer, each

payment is smaller.

**Strategy:** The owner-spouse could give an interest to his spouse prior to the sale. Structure the sale as a *joint and survivor annuity* to reduce the size of the annuity payments and ensure a lifetime income to the surviving spouse.

**Alternative:** The parent can forgive annuity payments required to be made. This results in income to the children—as discharge of indebtedness income.

- ☞ The parent must not be suffering from a terminal illness at the time of sale. The benefits from the private annuity depend on the use of IRS tables which cannot be used if a person's death is imminent.
- ☞ If the parent outlives his life expectancy, the portion of each annuity payment that had been capital gain becomes ordinary income.
- ☞ The children do not get any interest deduction for any part of the annuity payment.

**Note:** The use of a private annuity as an effective planning tool is not restricted to the business setting...

**A Non-Business Example:** Mary Smith, age 80, transfers real estate worth \$200,000 to her daughter Nancy. At current levels of interest rates, Nancy would have to pay about \$33,000 per year.

If Mary dies after two years (and \$66,000 worth of payments), that real estate worth \$200,000 would be out of her estate with no gift or estate tax consequences.

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**Have questions about private annuities or any other estate planning issues? Contact us.**

**Also, call our Toll-Free 24 Hour Estate Planning Tips Hotline: 1-888-254-5450**



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[www.estateplanning.com/pricefarr](http://www.estateplanning.com/pricefarr).

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### Tax Season Quotes:

"Next to being shot at and missed, nothing is quite as satisfying as an income tax refund."

—F.J. Raymond

"This [i.e. preparing my tax return] is too difficult for a mathematician. It takes a philosopher."

—Albert Einstein

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